ECB Cheat Sheet: Predictably unpredictable

Inflation data support ongoing hawkish rhetoric at the ECB but financial stability risk has markets substantially re-pricing the path for policy rates lower. The risk of miscommunication is high at this meeting; our call for one last spike in rates before the end of this cycle is now conditional. The other side of the Atlantic should keep driving EUR/USD

Scenario analysis: How to position for Lagarde's alternatives

	Inflation outlook	Growth outlook	Interest rates	Quantitative tightening	EUR/USD (1.07)	10Y Bund (2.20%)
Current stance	Inflation far too high but risks to inflation outlook are now more balanced	Recession should be short and shallow. Growth subdued. Risks more balanced	Depo at 2.50%. 50bp in March, more tightening necessary	APP holding declining at €15bn p.m. PEPP reinvested at least until end '24		
Dovish	Medium-term infl. may return to target earlier than previously thought	Higher risk of a sharper/longer-lasting economic slowdown	**50bp hike.** Worsening outlook suggests slower pace of tightening	APP reduction can be paused if necessary	1.06	2.40%
ING Base Case (neutral)	Unchanged. Inflation to stay high but 2025 outlook at 2%	Unchanged. Risks still more balanced than earlier	**50bp hike.** Switching to data dependency with hawkish tone	Unchanged, aim to end APP reinvestments by year-end	1.07	2.60%
Moderately hawkish	Stressing how core inflation may stay higher for longer	Outlook has improved, balance of risks continues to improve	**50bp hike.** Reliable hints of at least two more hikes, open to 50bp hike in May	Hint at stop of APP reinvestments before year-end	1.08	2.70%
Very hawkish	Expecting rebound in inflation to last, medium term above 2%	Balance of risks tilted to the upside, outlook much improved	**50bp hike.** Forward guidance for another 50bp in May	PEPP reinvestments may stop in 2023	1.09	2.80%

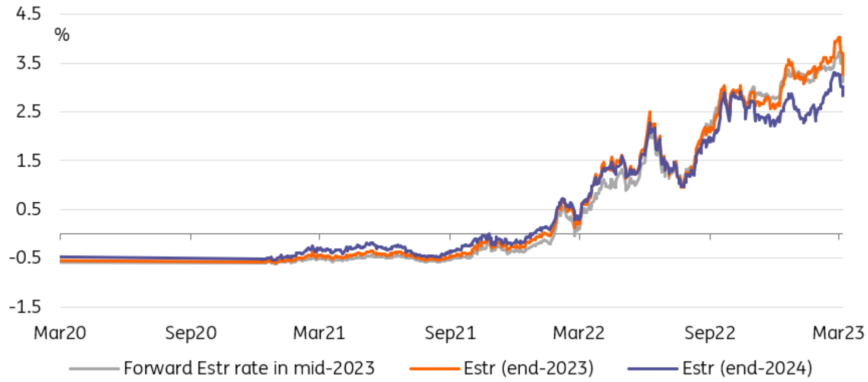
Source: ING

Given the ECB's strong guidance around a 50bp hike at the March meeting, all our scenarios in this edition of the ECB Cheat Sheet imply a 50bp move, and the degree of data dependency, forward guidance, along with views on inflation and growth should drive the market reaction within the dovish/hawkish spectrum. The recent developments in the US banking sector and large swings in rate expectations both mean that a 75bp move is looking even less likely and that 25bp may be discussed. Our economics team does not see a very material risk of a 25bp hike this week and only expects recent market developments to affect the debate about the path beyond March, but should the ECB surprise with such a smaller move, it would entirely be due to financial risks as opposed to a more constructive view on inflation.

The European Central Bank signalled a 50bp hike at the March meeting and an update to its staff economic forecast suggest the debate about further policy steps will become more heated. That debate is further complicated by fears of US regional banks facing deposit outflows.

On paper, the central bank is data-dependent, and so future moves will only be decided at each meeting, but President Lagarde and colleagues are struggling to kick the forward-guidance habit. Previous attempts at communicating the nuances of monetary policy decisions in the press conference have resulted in outsized, and quickly reversed, market reactions. This is to say nothing of financial stability risk spreading from the US financial system. The ECB is now torn between adding fuel to the fire by delivering the promised hike, and further falling behind in a fight against inflation it is already losing.

Markets see rising financial stability risk as a brake on the ECB's ability to hike



Source: Refinitiv, ING

Buckle up! Near-term jitters as the ECB struggles for a common stance

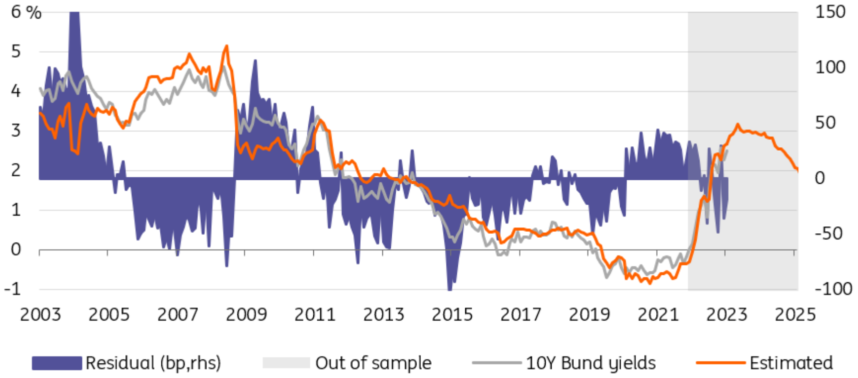
A good starting point in trying to predict the near-term market impact of the March ECB meeting is how far the market has gone since the last one. In a nutshell, they moved a lot, and with reasons. Core inflation continues to rise, and to surprise to the upside. This has been a key driver of the swap curve moving its implied deposit rate at the end of this year by 75bp after the last meeting to over 4% at some point last week. Our own call is slightly lower, around 3.5%.

> *Recent history is full of examples of markets mis-reading the ECB's hawkish intentions*

Difficulties in finding a common ground, let alone communicating it, could result in markets getting the impression that the ECB is wavering. To put it bluntly, this would not necessarily be the right conclusion: the ECB can be trusted to continue hiking until it is confident inflation is coming back under control. Recent history is full of examples of markets mis-reading its hawkish intentions, however. The latest example to date is February 2023, but October 2022 also comes to mind.

Given the jump in rates and increasingly vocal doves, we think the risk of a drop in front-end rates around this meeting is high. This would be the wrong reaction in our view, and the move may well be retraced. It is a fool's errand to try to predict Lagarde's exact message, but with higher rates than at the last meeting, and rising stress in financial markets, pressure to sound hawkish is that much lessened.

We'd expect one more peak in EUR yields before the end of this ECB tightening cycle



Source: Refinitiv, ING

Longer term, higher rates and more bear-flattening are on the cards

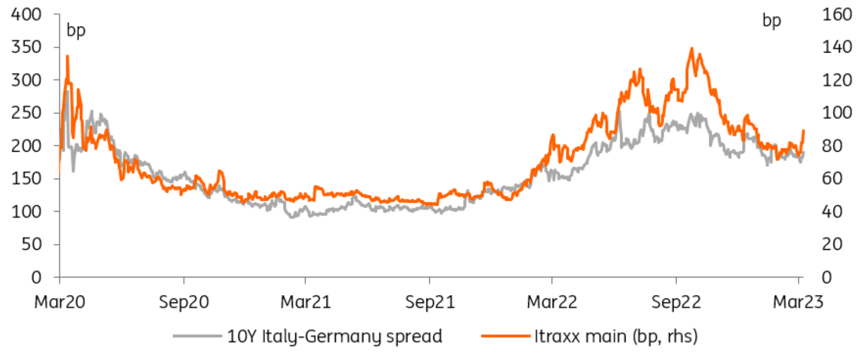
One shouldn't mistake a knee-jerk drop in front-end rates, and associated curve steepening, for the beginning of a new trend. Even after their re-pricing, we continue to see a case for higher yields. Based on historical relationships to domestic financial indicators alone, we would expect long-term yields to continue rising until much closer to the end of the ECB's hiking cycle. At face value, we could well see 10Y Bund yields stabilise around 3% for most of this year but this is premised on the ECB actually deliver hikes, something financial markets are increasingly doubting. In practice, a slowing economy and Fed cuts coming into view by year-end means we expect the Bund to end the year closer to 2.25%.

Translating this into 10Y EUR swap rates, this should mean a jump towards 3.5% is not out of the question, before a drop back through 3% by the end of the year, in fact to 2.75%. Needless to say, our call for higher EUR rates is contigent on worries about one US bank's failure not escalating into durable system-wide angst.

> *The ECB has to sound like it is on its front foot to avoid another jump in inflation expectations*

One key variable to look at to see if long-end bonds find support at current yields levels is inflation swaps. The upside surprise to eurozone inflation in February sent them higher, while a barrage of hawkish ECB comments staved off further rises. Therein lies the key to long-end rates remaining in check: the ECB has to sound like it is on its front foot to avoid another jump in inflation expectations. Judging from a wide range of diverging opinions going into this meeting, and in the difficulty for Lagarde in finding a common message to communicate, we see more near-term upside to EUR rates.

Even if contagion risk is still small, the ECB is unlikely to accelerate QT



Source: Refinitiv, ING

The quantitative tightening bargaining chip

Our impression has long been that the ECB's balance sheet, and the roll-off of its asset portfolios in particular, has been used by the ECB's hawks as a bargaining chip in trying to elicit bolder action on the rates front. Normalisation is an important aspect, but interest rates are still the ECB's main policy tool.

In that case Bundesbank's Nagel, calling for a moderately faster reduction of the Asset Purchase Programme portfolio starting in the third quarter while still urging action on rates, sounded more like an early concession. The amount of €20bn per month he called for is not yet in effect a full stop of reinvestments and is also in line with the market consensus. We think Austria's Holzmann calling for the inclusion of the Pandemic Emergency Programme (PEPP) in quantitative tightening in autumn can also be viewed against the backdrop of pre-positioning for heated Council discussions. However, his remarks do stand out as being the first time that an ECB member has openly questioned the current forward guidance on PEPP reinvestment – this still foresees full reinvestments until at least the end of 2024.

Flexible reinvestment of PEPP maturities forms the ECB's first line of defence against sovereign spread turmoil

Yet the PEPP is more than just another sizeable balance sheet item waiting to be wound back. The flexible reinvestment of PEPP maturities forms the ECB's first line of defence against sovereign spread turmoil. Unlike the much touted and in theory certainly powerful Transmission Protection Instrument, it comes with a relatively low bar for deployment and has actually been used and tested already. Sovereign spreads have proved remarkably resilient during the ECB's tightening drive, but especially considering the latest stress surfacing in corners of the US banking system we think the ECB will not want to rock the boat.

FX: ECB not the primary driver of EUR/USD

EUR/USD approaches the ECB March meeting with a big deal of volatility and external factors affecting it. The two-year EUR-USD swap rate differential has narrowed from the 140bp area to the 90-95bp area (at the time of writing) following the SVB collapse and rising bets on a Fed U-turn. However, EUR/USD has only risen modestly, and this is because global risk sentiment also took a hit and that is statistically the most important driver for the pair while short-term differentials have lost predictive power recently. We estimate only a 1.5% short-term undervaluation in EUR/USD.

Where does this leave EUR/USD when it comes to the ECB impact on Thursday? While FX volatility will be higher into the ECB announcement, the latest price action clearly confirmed that EUR/USD is much more closely tied to risk sentiment than it is to short-term rate dynamics. In the current environment, decisions taken in Washington and incoming news on the health of the global banking sector are more important drivers for sentiment than the degree of ECB hawkishness. So, even if a volatile FX market will be inevitably sensitive to Lagarde's words, we suspect the impact on EUR/USD may be out-shadowed by news on the banking front.

In terms of the direction of the ECB impact, we outlined in this preview how there are still non-negligible risks of communication missteps by the ECB, which are probably exacerbated by the recent turmoil. **Accordingly, the balance of risks based only on the ECB-reaction appears tilted to the downside for EUR/USD. However, should we see the Fed reassure markets with a more dovish tone, and global sentiment rebound, it would take a big dovish ECB surprise to prevent a EUR/USD rally.**

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